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Inside

FYI

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The Role of the CPA in an M&A Transaction: A Lawyer's Perspective

Over the next ten years, more than 76 million baby boomers are scheduled to retire, according to the Institute for the Future. Many of these retirees are business owners who are seeking to transition out of their business by merging with or being acquired by other businesses. CPA firms have the opportunity to help them make this transition. In the following article, two lawyers who have been involved in such transactions offer their perspective on the CPA's role.

By William H. Venema and Scott D. Cheskiewicz

Closing a merger and acquisition (M&A) transaction requires a team of people. The seller's team usually includes the CEO, CFO, in-house counsel, and other employees, while the buyer's team includes the individuals within the buyer's organization who are responsible for the transaction. Both teams also include outside professional advisors such as outside legal counsel and perhaps a financial advisor. One of the most important outside professional advisors is the outside CPA. Unfortunately, the CPA's role in the process is often poorly defined, if it is defined at all. In our opinion, buyers and sellers alike should spend some time defining the roles of all of their team members, especially that of the CPA.

The roles of the various team members overlap. Accordingly, it is important to assign the roles and responsibilities carefully to ensure that the team functions in a coordinated manner. CPAs provide unique and essential advice with respect to each of the areas discussed here.

Preparing for the transaction

In an M&A transaction, both the buyer and the seller conduct due diligence. The seller's due diligence focuses on preparing the company for sale, while the buyer's focuses on determining the condition of the company.

In preparing for the transaction, the seller's CPA needs to ensure that the seller's management team thoroughly understands what is revealed in the financial statements that the CPA prepares. In particular, the CEO and CFO need to be able to explain any anomalies. The seller's CPA can also help the seller maximize the purchase price of the company by advising the seller concerning ways to make the company more attractive to a buyer. One such way is to "clean up" the financial statements by disposing of noncore assets that are more perquisites for management than they are key components of the business. The cleanup could also involve such things as adjusting any excessive

Six Key Responsibilities of the CPA

1. Helping to prepare for the transaction.
2. Assisting with valuation.
3. Determining optimal deal structure.
4. Creating a purchase price adjustment process.
5. Establishing earn-out parameters.
6. Advising on the tax aspects of noncompetes, consulting agreements, and personal goodwill.

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compensation and getting rid of family members who are on the company payroll but do not actually perform any work for the company.

The buyer's CPA also has a critical role during the early stages of the M&A process. A central aspect of the buyer's due diligence is the CPA's review of the target company's financial statements and other accounting records. The CPA's review has three basic purposes:

- Identify and advise with respect to any material financial issues, for example, accounting errors or extraordinary items that are found in the seller's past financial statements, the footnotes thereto, or the audit papers of the seller's accountants.
- Determine whether the target company's accounting practices conform to generally accepted accounting principles (GAAP), and if not, what accounting practices were used and what effects they have had.
- Evaluate what the target company would look like if it had used the buyer's accounting practices, even if the target company's practices complied with GAAP.

Valuation

Although sellers are often advised by investment bankers on the issue of valuation, the seller's CPA also plays a critical role because valuation techniques are ultimately based on the company's financial statements. If the company's financial statements are flawed or misunderstood, then the valuation analysis will be incorrect. Accordingly, to understand the value of the seller's company, the seller will need the assistance of a CPA to ensure that the seller's financial statements are correct, and that its valuation analysis is based upon proper assumptions about the financial condition and performance of the company.

Buyers have their own ideas on how to value a target company. Again, however, the analysis is usually based on the target company's financial statements. For example, if the company is being valued based on a multiple of earnings before interest, taxes, depreciation, and amortization (EBITDA), then it is essential for the buyer to understand what accounting practices were used in deriving that EBITDA. What kind of revenue recognition principles did the target follow? Were certain expenditures capitalized that should have been expensed or vice versa?

We know of a transaction where a public company purchased a private company without preparing pro forma financial statements based on the buyer's accounting practices. Although the private company's revenue recognition practices complied with GAAP, they were inappropriate for a public company because of rules promulgated by the Securities and Exchange Commission. Unfortunately, the public company buyer based its valuation analysis on the seller's financial statements without examining the seller's revenue recognition practices. The result? A very unhappy buyer and an extremely expensive postclosing dispute.

Deal structure

Ultimately, the buyer and the seller must determine the structure of their transaction (that is, whether it is a stock deal, an asset deal, or a merger). Clients usually involve their attorneys in this process, but far too often, they fail to include their CPAs. The structure of a transaction is often driven by tax considerations. Attorneys tend to focus on the theoretical aspects of tax considerations, while accountants usually take a more pragmatic approach that focuses on the actual financial condition, performance, and goals of each of the parties. Both perspectives are important.

Including the CPA's perspective in the process of selecting a transaction structure will ensure that the parties select the structure that is the optimal one for them. For example, does the seller have net operating losses? If so, can the transaction be structured in a way that will enable the buyer to use them? What is the nature of the seller's assets? Can the buyer's basis in the assets be allocated in such a way that the buyer is able to take larger depreciation deductions, and thereby, save on future income taxes? Are any of the tax-free reorganizations applicable? The answers to these questions and more will depend on practical considerations that are usually the purview of the CPA.

Not only are accountants invaluable in determining the structure of an M&A transaction, they can also play an important role in determining whether an M&A transaction is the right transaction. For example, there are instances where a leveraged employee stock ownership plan (ESOP) transaction might provide a greater after-tax return to a seller than a traditional sale to a strategic or financial buyer. Only a skilled accountant who has a full understanding of the tax savings available in a leveraged ESOP transaction and can dig into the actual financial data of the company can make that determination.

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Editor: **William Moran.**

Purchase price adjustments

In transactions with closings that occur some time after the execution of the definitive transaction documents, and often because of the inherent lag in production of financial statements, purchase price adjustment provisions are normally included in the purchase agreement. The purchase price adjustment is a mechanism to compensate the buyer or the seller for changes in the target company's business that occur between the most recent financial statements that are available when the documents are executed and those that are dated as of the closing date.

Purchase price adjustment provisions are fraught with accounting-based problems. The CPA must consider what accounting practices were used to prepare the most recent financial statements at the time the documents are signed. These statements play an important role in determining the purchase price. The CPA must also consider what accounting practices will be used to prepare the closing financial statements, prepared as of the closing date. To adjust the price based on the company's operational performance between signing and closing, these accounting practices must be fully understood and agreed to by the parties and, most important, they must be identical. If they are not, then the seeds of a postclosing dispute have been planted.[1] Moreover, the provision will not achieve its intended purpose because, if the accounting practices are not identical, the parties will, in effect, be "comparing apples to oranges." Many attorneys are unaware of this pitfall, as evidenced by the many form purchase agreements that fail to properly address these issues.

Earn-outs

Accounting issues also play a key role in drafting earn-out provisions. An earn-out is a contractual provision that provides additional consideration to the seller if the company achieves certain financial targets within a specified period following the closing.[2] Earn-outs are often used in purchases of relatively new target companies or when the buyer and seller have significantly different opinions on the value of the target company. All of the accounting pitfalls mentioned above with respect to purchase price adjustment provisions apply to earn-out provisions as well. In addition, earn-out provisions must consider practical considerations, such as how the targets are defined and whether they are obtainable. Whose accounting practices will be used to measure the company's performance—the buyer's or the seller's? Who will be doing the measuring—the buyer, the seller, or one of their CPAs?

Like purchase price adjustment provisions, earn-out provisions can be the source of significant postclosing disputes if they are structured improperly or misunderstood by the parties. In far too many purchase agreements, short-cuts are taken in addressing these issues, thereby forcing them to be sorted out later in costly postclosing disputes. Accountants who fully understand these issues can advise the buyer and the seller concerning how to address them while negotiating the transaction, instead of leaving them to be decided by a third-party arbitrator or a court.

Noncompetes, consulting agreements, and personal goodwill

In any transaction involving a founder or an owner who has played an important role in the target company, the seller will probably want to include a noncompete agreement as part of the transaction. Because the payments under the noncompete agreement can be expensed by the buyer, there are rules concerning the extent to which a party in an M&A transaction can be compensated under a noncompete agreement. The parameters of these rules are often better understood by the CPAs. The accountants for the buyers and the sellers should ensure that this issue has been addressed properly in the transaction documents.

Personal goodwill is a concept that is related to the principles that govern the amount of compensation that can be allocated to a noncompete. In a transaction structured as an asset sale of a closely-held private company, the majority selling shareholder's tax liability can be reduced by the use of a consulting agreement. By using consulting agreements, a portion of the purchase price can be paid directly to the selling shareholder or consultant, thereby avoiding the double taxation that would arise if it were first paid to the company and then distributed to the shareholder. In certain circumstances, a CPA can help reduce the tax burden even further by suggesting the sale of the owner's personal goodwill.[3]

Understanding roles

In order for an M&A transaction to run smoothly and efficiently, the team members of the respective parties must understand their roles. Often, the parties give this matter too little attention, especially with respect to the role of the CPA. By considering the issues addressed

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[1] For a more detailed discussion on the pitfalls associated with what happens when different accounting practices are used in connection with a purchase price adjustment, see *Purchase Agreements: How One Common Flaw Can Cost You Big Money!*, JOURNAL OF CORPORATE ACCOUNTING & FINANCE, January/February 2007.

[2] Earn-outs can also be structured such that the seller must pay back certain funds if performance falls below a certain threshold, but this practice is far less common.

[3] For more information on using personal goodwill in an asset transaction, see "Selling Personal Goodwill: A Winning Strategy for Clients?" *CPA EXPERT*, Winter 2006.

in this article, as well as others that might apply to a particular situation, the parties and the other team members can gain a better understanding of the important role that the CPA should play in an M&A transaction. As a result, the teams will be able to function in a more coordinated and effective manner.

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Making Your Performance Management System Work

*Strong performance management systems support employee development and retention. However, managers and human resources professionals alike are disenchanted with their performance management systems, according to a study by OnPoint Consulting (**www.onpointconsultingllc.com**). The following article discuses some guidelines suggested by OnPoint for enhancing a performance management system.*

When you look at your to-do list, do you feel overwhelmed? For some managers, however, the long daunting list may be a welcome sight at times, especially when the list includes the task of completing performance evaluations of direct reports. If other important issues require attention, perhaps performance evaluations can be postponed further, or if not, they can be completed by filling in a sentence or two on the evaluation report, checking off some ratings, and then asking each direct report to review the forms and sign them. This will save time and allow the completed forms to be sent to Human Resources (HR) reasonably close to deadline. It will also contribute to defeating the purpose of the performance management system.

For many professionals, performance management is a dreaded chore with little obvious payoff. In fact, a recent survey done by OnPoint Consulting involving 115 HR professionals and 441 line managers found that more than half of the respondents have a negative view of their companies' performance management systems.

"We found that only 44% of the line managers and 45% of the HR professionals believe their companies' current performance management systems deliver value to the business," says Jennifer Forgie, managing partner at OnPoint. "Furthermore, only 43% of line managers and a surprising 46% of HR professionals believe the time spent on their performance management systems is worth the investment. And only a paltry 30% of respondents say their systems achieve their intended objective to a 'great' or 'very great' extent."

Frequent, but ineffective adjustments

Consequently, many organizations fiddle with the details of their performance management systems, adjusting rating scales, adding or revising competencies, or moving from paper-based to software-enabled systems and so forth. In fact, 60% of study participants report that their performance management systems have been changed in at least one way in the past three years.

Such adjustments, however, are apt to be ineffective. Forgie reports, "Only 24% of respondents believe that reported changes actually improved their organizations' performance management systems. Furthermore, more than half of the respondents with the worst performance systems report that they have made changes to their systems in the past three years."

Suggested solutions

If an organization is dissatisfied with its performance management system, it has no choice but to change to a new one. OnPoint does suggest some helpful insights. However, it cautions that there are no one-size-fits-all solutions. Here are the four suggestions:

1. *Resist the temptation to keep tinkering with the evaluation process.*

Almost any system will work if managers are committed to using it. As mentioned earlier, organizations like to fiddle with performance evaluations. "But these organizations are missing the forest for the trees," says Forgie. "They don't seem to notice the serious disconnect between improvement efforts, success factors, and obstacles." She points out, "The system components that people seem to change most frequently do not directly address the primary obstacles we discovered

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in our survey: lack of clarity of the relationship between pay and performance, inconsistent application of the system, lack of commitment to developing people, and lack of managerial skills. Generally, it's a user problem, *not* a system problem. Pick a system, commit to it, and make sure everyone is on the same page."

2. *Ensure that your performance management system has the six critical factors that impart fairness, accuracy, and value to the business.*

Seventy-five percent of OnPoint's survey respondents say they believe it's possible to develop a system that fairly and accurately measures employee contributions to business results (though only 40% believe their current systems fit that description). Three factors tend to earn a system the "fairness & accuracy label":

- The system helps employees build their skills and competencies.
- The system is applied consistently across the company (for example, managers set goals with employees, and there is a shared picture of the criteria used to evaluate performance).
- The rating scale enables managers to accurately differentiate levels of performance during the annual reviews.

Three additional factors affect not only the perception of fairness and accuracy but also the perception of overall business value, leading employees to believe the system is worth the time invested. These factors are:

- Helping to build a high-performance culture.
- Providing data that is useful for succession planning.
- Providing useful data that drives leadership development initiatives.

3. *Train managers in all four elements of performance management: goal setting, coaching, development planning, and performance evaluation.*

"Managerial skills in these four areas are absolutely essential for the success of any performance management system," says Forgie. "Without these fundamental skills in place, no form, rating scale, or technology will make the system work." Forgie also explains, "Organizations seem to recognize the importance of skill training, but the focus appears to be on the annual evaluation meeting." The majority of companies in OnPoint's study, 62%, provide managers with training to conduct effective performance evaluations. Yet fewer organizations—only 53%—provide the skill training related to setting goals and coaching and feedback. "This appears to be at the core of the problem," says Forgie. "If you don't have clear, measurable goals in place and provide ongoing coaching and feedback, it's almost impossible to have an end-of-the-year appraisal that employees see as fair and accurate, no matter how well the manager conducts the meeting."

In addition, the study found that only 46 percent of companies surveyed provide training in development planning. "This is surprising," says Forgie, "because we know that solid development planning has a positive effect on retention. We found that in 2006, voluntary turnover was much lower in the companies with the best performance management systems. Twenty-six percent of the companies with the best performance management systems experienced turnover of less than 5%, compared with only 9% of the companies with the worst performance management systems."

4. *Hold periodic review meetings with employees.*

OnPoint found that the best performance management systems either require or encourage quarterly or periodic review meetings—not including the annual performance evaluation. Given the importance of ongoing feedback and coaching, Forgie says she is surprised that 42% of respondents in the study report that periodic reviews are not a formal part of their performance management systems.

Forgie reports, "In those companies where periodic meetings are not a formal part of their systems, only 43% provide positive ratings on the statement 'managers provide effective coaching and feedback,' compared to 71% where they are required, and 62% where they are encouraged. In addition, we found that requiring managers to conduct regular 'check-ins' ties directly to higher positive ratings for 'the system helps employees build their skills and competencies'—one of the key factors that affects the perception that a system is fair, accurate, and delivers value to the business."

The bottom line

Forgie says, "You must help your leaders understand the purpose of your system and why it's an important part of their jobs. Ultimately, until they understand why performance management matters, they'll treat it as busy work that they must get through in order to move on to their real jobs."

"When your managers understand how performance management is linked to your company's larger goals—how it drives the business and adds value to the company—they'll quit seeing it as an administrative task," says Forgie. "That buy-in is everything. Get it, and you'll see a whole new attitude toward performance management . . . which can transform the entire culture of your company."

An Imminent Era of Entrepreneurs

The face of small business will change dramatically. The change probably will affect the market for CPA firms' services. The change will also affect how CPA firms recruit and deploy professionals to provide services. The following article, based on a recent Intuit study, describes the reasons for the change and what the change is expected to look like.

Social, demographic, and technological developments have converged to create a diverse pool of people who are choosing entrepreneurship over traditional employment situations. This is a finding of the "Intuit Future of Small Business Report" on a study that Intuit and the Institute for the Future undertook "to better understand this segment of the U.S. and global economy" by identifying, analyzing, and forecasting "the significant trends and forces impacting small business over the next decade." The report is the first installment of a series of reports on "The Intuit-Institute for the Future (IFTF) Future of Small Business Project."

In general, the report concludes that small business growth will continue to contribute to the United States' economic growth, and this growth will have a social and economic impact. More specifically, a sidebar on the second page of the report succinctly summarizes its findings: "Small business ownership will become increasingly common and diverse, new forms of small and personal businesses will be created, and educational and training programs will shift and expand to support small businesses." For CPA firms and their clients, the findings of the report have implications concerning the markets they serve, as well as how they serve these markets.

Economic decentralization

Two past eras are cited in the report as the basis for an emerging economic transformation. The first era was the period of social transformation during the 1960s and 1970s when women, minorities, youth, immigrants, and the disabled challenged traditional institutions, including business. A period of technical disruption (1980s and 1990s) followed. Personal computers and the Internet prepared the way for new, as well as "disruptive," business models. Entrepreneurial activity increased as the growth of the digital infrastructure helped to reduce start-up and operating costs of small businesses and opened new markets to them. The report predicts that in the next decade, the two earlier movements will "combine to transform the economic landscape and begin an era of economic decentralization."

Three emerging trends

In the next decade, the report predicts, three emerging trends will affect small business formation and operations:

1. *The changing face of small business.*
2. *The rise of personal business.*
3. *The emergence of entrepreneurial education.*

Perhaps most noteworthy of the trends is the rise of personal business. Personal businesses differ from small businesses. Usually they are home-based and have no employees. They include contract employees, part-time employees, and hobbyists. Often personal businesses are an extension of previous work relationships. People with personal businesses are unlikely to think of themselves as small business owners. However, a personal business sometimes grows into a small business.

At the end of 2004, almost 20 million Americans operated businesses with no employees, according to the U.S. Census Bureau. Businesses without a payroll account for more than 70% of the nation's businesses.

A shift from traditional employment

Economic, social, and technological changes have contributed to the rise of personal businesses. Fewer large companies offer long-time job security. Many have downsized and have reduced the attractiveness of health care coverage and pension plans. Many organizations accommodate employees' increasing desire for work-life balance by establishing telecommuting programs and flexible work schedules. Still, opportunities created by the Internet have prompted many to establish their personal businesses. The flexibility offered by a personal business has prompted some dual-income families to organize a hybrid structure for their careers: One spouse works in a corporate job with corporate benefits, thereby allowing another family member to start a more risky personal business. This model also can help to relieve the stress that results from ensuring proper childcare and can help contain the costs of commuting and childcare expenses.

Intuit expects the line between small and large businesses to "blur." The reason is that people will respond to the demise of lifetime employment by contracting as free agents with large companies. These free agents will have clients, not employers. Their having less security will be balanced by their having more control over their time and working conditions.

Some professionals will alternate between the personal business world and the corporate world. This is because corporations and government agencies look upon entrepreneurs as promising candidates who will foster innovation.

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PCPS Update

AICPA Private Companies Practice Section

This month we feature several learning and practice enhancement opportunities available to PCPS members.

Mark Your Calendar for These Online Practice Management Forums

Since they were introduced last year, the PCPS online Practice Management Forums have become a very popular way for PCPS members to gain insights and inspirations on hot topics. The sessions are given by nationally known speakers, and each one features a live PowerPoint presentation and a special Q&A segment where you can ask questions about issues facing your firm. Upcoming forums include:

- "Managing Difficult Conversations Successfully," given by Jennifer Wilson on June 14.
- "Why Clients Leave," given by Allan Boress on July 17.
- "Align Your Firm for Success: The 7 S Framework," given by Deb Lockwood on August 21.
- "The Risk Assessment Standards," given by Chuck Landes on September 18.
- "Recruiting in the 21st Century," given by Mark Koziel on October 23.
- "Succession Assessment: Is Your Firm Being Realistic?" given by Robert J. Gallagher on November 20.
- "Build and Run a Successful Financial Planning Practice: Best Practices and Slips to Avoid," given by Walter M. Primoff on December 18.
- "The Small Firm Advantage," given by Jim Metzler on January 22, 2008.

This value-added benefit is free to PCPS members. Each forum takes place from 2:00 PM to 3:30 PM, ET. PCPS members will receive e-mail announcements on how to register for each forum, so be sure to watch for them.

Build Your Firm's Future at the "Emerging Partners Training Forum"

Effective leadership training can improve retention and enhance your firm's long-term prospects for success. The unique, two-day "Emerging Partners Training Forum," developed by PCPS, provides hands-on training from nationally known consultants and successful firm leaders. The dynamic and multifaceted agenda includes sessions on growing your leadership talent; marketing and business development; client retention and satisfaction; management skills; and conflict management. Participants can also take advantage of valuable networking opportunities.

This year's Forum will take place on July 17 and 18 in Chicago. PCPS members who attend not only enjoy a registration discount but will also receive bimonthly support calls from the AICPA PCPS team to help them implement the ideas presented at the Forum. Graduates of last year's sessions can also attend Phase II of the Forum, which will take place on August 1 and 2. For more information, go to www.cpa2biz.com/conferences.

Seasonality Success Contains Post–Tax Season Tips

The 2007 Spring edition of *Seasonality Success: Winning Strategies for Profitable Firms*, an e-newsletter about making the most of the busy season and published quarterly by PCPS, has been released. This issue contains articles on:

- Getting the right service mix for maximum profitability.
- Using client surveys to measure your success and improve satisfaction.
- Ways to regain a high energy level after tax season.
- Using total quality management principles to enhance your firm.

There's also a quick guide to smart phones and which one is right for you. The issue can be found at ***http://pcps.aicpa.org/NR/rdonlyres/CF9818B5-5413-4216-BB98-A2D3AF42CC6A/0/Seasonality_SuccessMar_2007.pdf.***

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Who are the new entrepreneurs?

In the next decade, the typical launchers of small enterprises are much less likely to be noncorporate, middle-aged, white males, as were many entrepreneurs in the past. Instead, more than 76 million baby boomers scheduled to retire will likely seek flexible and part-time work arrangements. They will also create personal businesses, contract or consult with former employers, found or join firms whose mission will be to help solve social problems, build businesses around their hobbies, or start new business interests.

Some of the children of the baby boomers, those categorized as Generation Y, are expected to "emerge as the most entrepreneurial generation," seeing entrepreneurship as an opportunity to remain independent.

Women are expected to increasingly seek entrepreneurship. They will include "mompreneurs," mothers who start part-time, home-based businesses, often with the help of the Internet.

The United States Census Bureau reports that immigrant entrepreneurs are the fastest growing segment of small business owners today. In addition, data from the Kauffman Foundation show that immigrants form small businesses at a much higher rate than nonimmigrant Americans. Small business formation by immigrants is expected to grow regardless of changes in immigration policy.

Educating the emerging entrepreneurs

"Once taught in the school of hard knocks, entrepreneurship will become a mainstream subject, as fundamental to business education as accounting," says Brad Smith, senior vice president of Intuit's small business division. "These courses will help transform the very definition of an entrepreneur to include professionals from all walks of life."

At colleges and universities, programs in entrepreneurship have increased over the years, and the growth of such programs is expected to continue. The emphasis of these programs is expected to expand to small business ownership of all kinds, not just high-growth businesses backed by venture capital.

Entrepreneurship education will be included in the curriculum of primary and secondary schools, as well as trade schools, culinary institutes, and schools for the arts. In addition, there is a need for mid-career entrepreneurial education to support transition to small business ownership.

The first installment of the Intuit-IFTF report is available at ***http://httpdownload.intuit.com/http.intuit/CMO/intuit/futureofsmallbusiness/SR-1037_intuit_SmallBiz_Demog.pdf.***

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